Paris, May 2025

Securitisation

Why adjusting liquidity regulation is a necessary catalyst for the securitisation reform?

Executive summary

- This note aims to deep dive on one aspect considered in the recent EC consultation, concerning the liquidity treatment of securitisation in the banking prudential framework.
- This aspect is often overlooked, compared to the capital treatment and other issues.
- One of the main impediments to increase the demand side, as regards banks' treasuries as potential investors in the European securitisation market, is the unjustifiable liquidity classification and haircuts that are applied to senior tranches of European securitisations in the Liquidity Coverage Ratio (LCR) when owned by European banks.
- Over time, the share of ABS in banks' HQLA buffers (which amount to about 5.6 € trn) has been fluctuating from 0.2% to a maximum of 0.7%. This shows that the high haircuts applied in category 2B (25%/35%) work as a total disincentive for banks to invest (or make market) in securitisation.
- This disincentive for banks to invest in ABSs was probably an intended feature, inspired by the losses incurred by some banks having invested in US sub-prime securitisation. However, 15 years after the GFC, and given the highly protective framework developed in the EU, such disincentive is not anymore relevant.
- **LCR eligibility is a crucial aspect, not only for banks, but for the market as a whole.** Indeed, LCR eligibility is an important investment criterion for the banks but also for non-bank investors, who take this liquidity aspect into account in their investment decision, because an instrument with a favourable LCR treatment can be more easily sold to a bank when needed, and at a better price.
- Banks investing (or market making) in senior tranches of securitisation should not be seen as a source of financial stability risks. Senior tranches carry a small fraction of the risk of the securitised portfolio. Instead, it should be seen as an instrument of cross

border private risk sharing, contributing to increased EU financial integration, convergence in funding conditions, and improved resilience.

- So far, most studies have based their conclusions on secondary market volumes, which, given the small size of the EU securitisation market, may suggest that this market is not highly liquid.
- It is important to broaden the approach to other aspects of liquidity metrics, such as diversity of players, resilience in crisis times, and interaction with Central Banks monetary policies, to provide a more holistic view of the criteria which drive investment decisions[1].
- Such an approach suggests that the current parameters applied to senior securitisation tranches are too conservative and that their relaxation may unlock significant investment capacity without endangering financing stability.
- If the EU securitisation reform package fails to address the liquidity framework, the success of the project may be jeopardized, and the EU securitisation market is likely to remain stuck in a "chicken and egg" situation, where low liquidity reduces investor appetite, in turn reducing issuance volumes.

1. Analysing the liquidity of securitisation instruments

The measure of liquidity can be based on various metrics. Liquidity has such dimensions as market depth, i.e., measures of how sizeable a trade has to be before transactions costs increase, and the time that it takes to dispose of a block without disturbing the price. These may be measures by turnover and the ratio of absolute price change to trading within a period (commonly used as measure of market depth).

1.1. Risk Control study based on bid-ask spreads

A 2022 Risk Control study compared the relative liquidity of senior ABS and Covered Bonds, based on bid-ask spreads collected on all traded securities between 2010 and 2021. The study analyses 3 groups of instruments:

1. AAA-rated ABS versus AAA-rated CB,

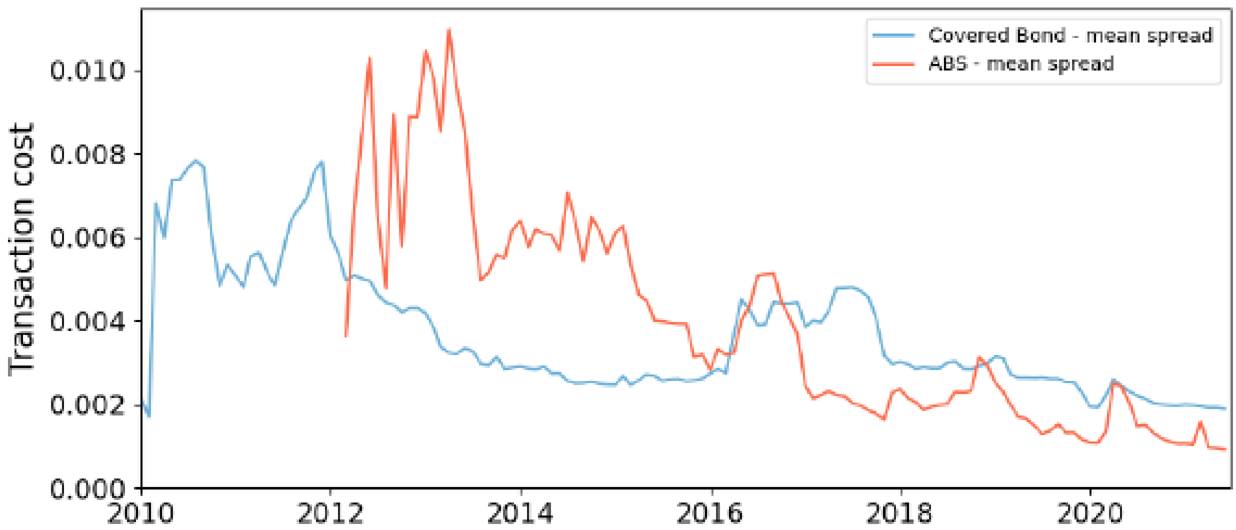
2. Investment Grade (IG) ABS versus IG CB and

3. Senior ABS versus CB.

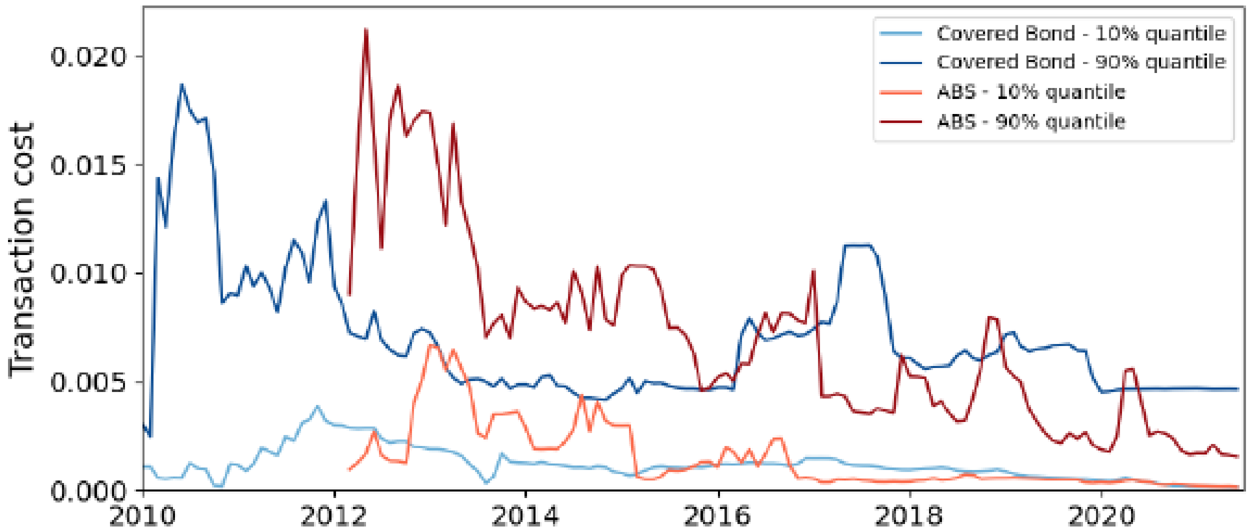
The most important finding is that, in the sample period which begins in 2012, CBs were more liquid for the first half of the period (during which the sovereign debt crisis occurred in southern Europe and the European Central Bank provided support to the CB market in the form of a substantial purchase program, see below). But senior ABS have been more liquid than CBs during most of the second half of the period (which includes the Covid 19 crisis).

Figure 1: Comparing AAA-rated CB and Senior AAA ABS

Panel A: Plot of average transaction cost



Panel B: Plot of transaction cost quantiles



1.2. 2022 Joint Committee assessment

As part of the December 2022 JOINT COMMITTEE ADVICE ON THE REVIEW OF THE SECURITISATION PRUDENTIAL FRAMEWORK, the Committee assessed the liquidity framework for securitisation and concluded: *"With regards to the liquidity framework, the JC considers that the current framework should be kept unchanged. Since the inception of the liquidity coverage ratio (LCR) the share of securitisations, including STS securitisations, in the LCR stress buffers has been negligible. This, in combination with LCR levels well above the minimum regulatory requirements, indicates that credit institutions do not rely on securitisations to face* *liquidity stress periods. Moreover, there is no new evidence on performance under a LCR stressed scenario, including the period covering the COVID-19 pandemic, to justify any prudent recalibration of the LCR with regard to treatment of securitisation positions."*

« The JC has therefore concluded that the current framework should be kept in its current form[2]. An upgrade of securitisations from level 2B to level 2A, which would mean that credit institutions would no longer be allowed to hold securitisations only up to 15% but up to 40% of their buffer for liquidity stress periods - without a test under stress - could lead to non-prudent results and jeopardise the sound liquidity position of credit institutions for stress periods. »

The Joint Committee justifies its views by focusing only on the period 2008 to 2012, considering that there has been no liquidity stress period since then, and therefore there would be no reason to expand the observation period.

A limitation of this approach is that the calibration period used by the Joint Committee includes only transactions that were issued BEFORE the implementation of the Basel 2013 new securitisation framework, and the 2019 EU STS framework. Therefore, none of the multiple safeguards that have been implemented (retention, disclosure, supervision of rating agencies etc.) are captured in this calibration, although they should be recognized as having a significant positive impact on market confidence and hence liquidity.

A recalibration based on post-2013 period seems therefore relevant, all the more that since the STS framework has been developed, transforming considerably the resilience of securitization transactions, the financial markets have experienced several episodes of heightened volatility (Covid, Ukraine war, UK LDI crisis,…)

1.3. Market views

As regards volumes in the secondary market, they are usually low, given, on one hand the overall market is underdeveloped in the EU, and on the other hand, investments are generally "buy and hold". To note, the ABS Purchase Program by the ECB, which peaked at a level of 25bn€, was also in a buy and hold approach, with most purchases occurring in the primary market, where the ECB bought up to 50% of new issues, subject to strict eligibility criteria.

Actually, the fact that most investors look at securitization as a buy and hold instrument should be seen as a factor of financial stability. Indeed, it shows that investors in securitization tranches are long term investors, unleveraged, and patient capital. This is in contrast with the situation prevailing before the GFC, where significant proportion of securitization tranches

[2] « However, the JC recommends modifying the LCR delegated regulation to reflect the increase in the granularity of CQS under the SEC-ERBA in accordance with the amended CRR and the Commission Implementing Regulation (EU) 2022/236511 amending the existing ITS laid down in Implementing Regulation (EU) 2016/1801 on the mapping of ECAIs´ credit assessments for securitisation positions. »

were held by Money Market Funds, exposed to a maturity transformation risk, and vulnerable to redemptions and fire sales. The EU MMF regulation has imposed a much stricter management of maturity transformation, shifting the ABS investor base toward long term credit investors.

In addition to *market liquidity* features through both outright sales and securities funding transactions (SFT) as relevant in an LCR context, the structural amortisation of securitisation transactions[3] implies a contractual liquidity inflow on every coupon payment date for all senior tranches, all the more so in case of *sequential waterfall* - where all the cash flows from the amortising collateral are channelled to the senior tranche only[4], as opposed to *pro-rata waterfall* where amortisation of collateral is spread to all tranches in proportion of their respective thickness (%). This specific contractual *amortising liquidity risk* provides a periodic[5] liquidity enhancement for every senior tranche holder of amortising deals that non-amortising HQLA such as bonds cannot offer until their redemption date (the liquidity of the latter over time relies on markets only: outright sales on secondary market and SFT).

In order to assess the impact of the ABSPP program on ABS market liquidity, the volume purchased in the ABSPP is to be compared with the Covered Bonds Purchase Program and the Corporate Bond Purchase Program. While the ECB had a stated objective of buying at market prices and not distorting market prices, ECB orders did impact significantly the prices, but in different magnitudes for Covered Bonds and for ABS.

While the ECB ABSPP did support the ABS market, the impact on price was much stronger in the Covered Bonds market, incentivizing banks to structure their eligible portfolios in Covered Bonds, rather than securitization formats, thus reducing further securitization issuance volumes. In turn, the presence of the ECB de facto excluded some private investors from the ABS primary market, as the spread became too tight to justify the involvement in the asset class, especially given higher due diligence costs. Typically, the range of private investors in Europe was in the order of 20, which is too limited to provide for an active secondary market.

At the end of the purchase program, the price correction was stronger in the Covered Bonds market, leading to normalization. On the ABS side, given the reduced investor base, the size of transactions was significantly impacted. Progressively, some investors have been coming back and ABS transactions size has started to normalize.

However, the investor base for ABSs remains structurally weak, given that banks and insurance companies are crowded out by their respective regulatory constraints. Therefore,

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[3] Unless some replenishment period applies, always subject to performance triggers.

[4] The thinner (%) of the senior at a point in time, the more the relative amortisation of that tranche.

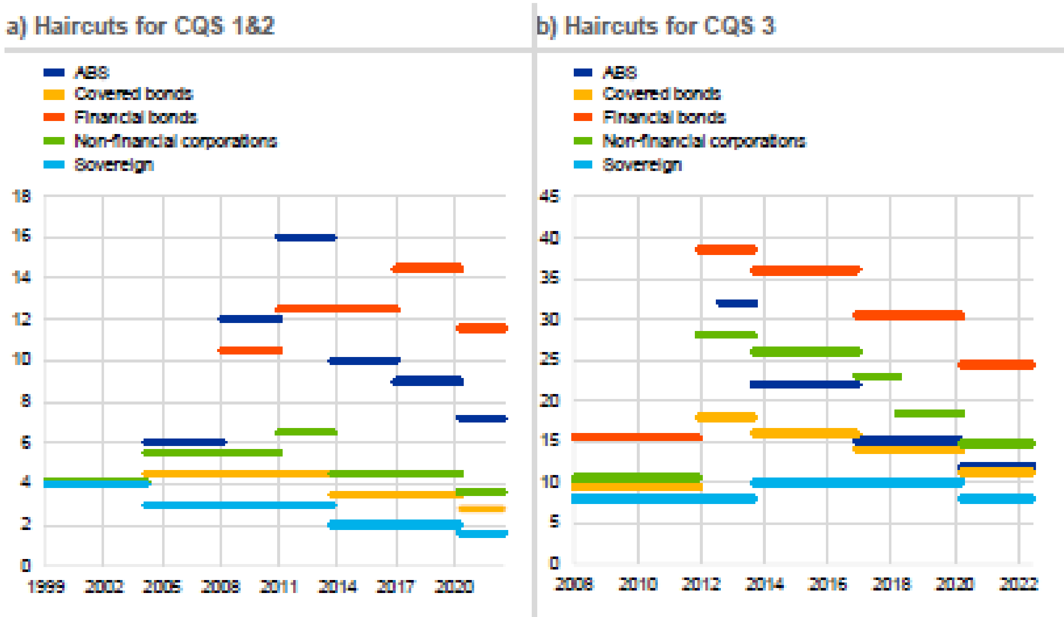
[5] Every three-month in most cases.

elasticity of demand, in front of a potential increase in issuance, is likely to remain weak, given investment funds are also subject to limits in the size of their individual investment tickets. Unlocking those barriers and broadening the investor base is a pre-requisite to develop a more deep and liquid market, able to absorb a significant scale up of issuance volumes.

The liquidity of an instrument is also linked to its eligibility as collateral to the Central Bank, which is an important feature, and should give comfort to better recognize ABSs in the LCR ratio. While the ABS market is a small portion of the ECB eligible collateral pool (600bn€ out of a universe of 18trn€), it is proportionally more used by banks as collateral (300bn€ out of a total of posted collateral of 1500bn€). This reflects the fact that many banks are issuing “retained transactions”, i.e., transactions which are not intended to be sold to investors, but to constitute a collateral pool that can be mobilized in monetary operations. About 50% of the volume of EU ABS issuance is retained. While this reduces the “free float” available to private investors, the fact that ABSs can be mobilized at the Central Bank is in itself an important element of the liquidity of the asset class which should be taken into account in the LCR framework. Consistency of eligibility and haircuts between the “theoretical” LCR framework and the “actual” monetary policy criteria would be an important step to realign regulatory liquidity ratios with actual liquidity risk management and avoid misalignment of incentives.

As a matter of reference, here is the comparison of the history of haircuts applied by the ECB on various eligible asset classes[6]:

Evolution of ECB valuation haircuts (in percentage) for various marketable debt asset classes with a maturity of around six years since 1999



Source: ECB.
Notes: The haircuts for covered bonds shown in the chart relate to “jumbo” covered bonds. A jumbo covered bond is an EEA legislative covered bond with an issuing volume of at least €1 billion, for which at least three market-makers provide regular bid and ask quotes.

[6] https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op312~3f4457b95c.en.pdf

Low secondary market volumes are also driven by further obstacles:

- the burdensome due diligence process, notably the requirement for any secondary buyer to re-verify compliance with each of the 100+ STS criteria, which prevents fluid execution of transactions with normal time-to-market, as well as
- the punitive prudential treatment for banks, which impacts not only the willingness of banks to invest, but also the appetite and the price at which a market maker may be willing to buy from clients in the secondary market, given associated liquidity and capital costs.

Given securitisation is generally a small portion of investors' portfolios, these instruments are less likely to be sold in case of significant liquidity needs. In particular, given ABSs are typically floating rate notes, they are not impacted by monetary rate moves, which does not generate incentives to sell or buy, in periods of monetary policy adjustments, compared for example to bonds which are generally fixed rate.

This being said, "contingent liquidity" remains an essential criterion for investors, as they need to be able to sell if and when needed, in particular in a period of stress. One of the recent episodes of liquidity stress was the UK LDI crisis, where asset sales were actually concentrated on ABS assets (selling sovereign debt would have crystallized significant Mark to Market losses, and Private Equity/Private Debt holdings are by definition illiquid). It is interesting to observe that ABS secondary market volumes have INCREASED, rather than decreased, in such a stress episode. Buyers were predominantly US banks, given they were not subject to the same burdensome due diligence process as EU banks, and could therefore react more promptly. Similarly, at the beginning of the COVID-19 pandemic, when corporate treasurers removed cash from Money Market Funds, asset sales by MMFs were concentrated on the ABCP market, and secondary volumes increased sharply, while those instruments are generally kept until (short) maturity.

The liquidity of a market fluctuates over time, and should be analysed also based on the nature, number and diversity of market players. Different types of market players have different mandates, and consequently different behaviours in stress periods, and diversifying the type of players provides resilience. For example, it is beneficial to have « solid hands » that can keep the assets with a long-term view, irrespective of short-term volatility (this would be the case for insurance and pension funds), but also « opportunistic investors » that can step in if they see value, such as hedge funds.

Overall, in the recent episodes of market stress, the ABS market has been able to absorb higher, not lower volumes. Taking into account this "conditional liquidity", i.e., the liquidity, not in normal times, but in times where investors want to sell, is essential, rather than focusing only on "normal times" secondary market volumes.

Finally, whatever the instrument, its liquidity will vanish if the crisis is centred on the instrument. This may impact any instrument, including the most « liquid » one, such as the US Treasury market, which recently faced several episodes of heightened volatility. Hence, the liquidity of an instrument needs to be considered more holistically and, as regards the LCR calibration, a better diversification of the banks' HQLA buffer should be an important financial stability goal.

2. Recommendations

- The 2018 LCR Delegated Act which restricted the eligibility of securitisation assets in the liquidity buffer should be amended to better reflect the transformation of the EU securitisation framework.
  - Senior securitisation tranches subject to specific criteria (rating, asset class (RMBS, auto loans, SMEs, consumer loans …)) were eligible as HQLA since LCR implementation in 2014. Unfortunately, on 13 July 2018, the Commission published the final text of revisions to the LCR Delegated Regulation (applicable as of April 30, 2020) which, instead of improving the treatment of senior STS tranches of securitisations, maintained their classification as Level 2B assets, with an associated 25% haircut for RMBS and auto loans & leases, and 35% haircut for SME & consumer loans.
  - In addition, as pointed by the ESAs Joint Committee in December 2022 (JC/2022/66, recommendation 8 pages 93 and 94), the rating requirement has been unduly limited to CSQ1/AAA (versus AA- in the 2014 Delegated Act). This change was an unintended consequence of recent changes in increased granularity of credit quality steps ("CQS") as the 2019 LCR amendment did not update the securitisation specific rating scale.
  - Finally, the differentiation between STS and non-STS was achieved by fully eliminating non-STS from LCR eligibility, although many of the major SECR requirements apply to BOTH STS and non-STS (ie retention…). This eliminates around half of the ABS market, including asset classes that cannot reach the STS label, and Member states that cannot reach the CQS1 level.
- The current calibration de facto crowds-out banks from the ABS market as investor and as market makers, as evidenced by the average 0.2 to 0.7% share of HQLA assets ABS represent. The main obstacle is the level of haircuts, as when a bank buys 100 of ABS, in order not to deteriorate its LCR, it needs to finance it with 150 of cash, in case of a 35% haircut. Such a transaction is therefore totally dissuasive. The level 2A constraint of a 15% maximum share is much less of a biting constraint. Reducing the haircuts, potentially making them more granular, as is the case in the ECB collateral policy, and solving the issue of sovereign ceilings should be the focus on the liquidity reform. Other reforms such, as

due diligence (for bank investors) and reporting (for bank originators) are needed as part of a package of measures to make the European securitisation market an efficient market to finance the European economy.

- In that context, Paris Europlace reiterates the proposals it made in its response to the Commission's consultation:
    - To promote to Level 2A STS senior tranches, rated from AAA to AA-, with 15% haircut, with no collateral differentiation;
    - To re-introduce senior non-STS securitisations rated from AAA to AA- to classify as Level 2B, with the haircuts defined in the Delegated Regulation on LCR of 2014.

  While such changes would deviate from the Basel rules, it should be considered that they would reflect the much tighter framework implemented in the EU as regards the STS and non-STS framework, compared to the Basel much less prescriptive STC standard, which justify lower haircuts.

Appendix I. Reminder of LCR regulatory state of play

- **Currently, securitisations are treated unfairly in the LCR, which is unreflective of the true qualities of highly rated securitisations.**
- In the Liquidity Coverage Ratio framework, banks are required to hold a "High quality Liquid Assets buffer" (HQLA) covering their net liquidity outflows over a 30 days stress period.
- For the composition of this HQLA buffer, EU regulation differentiates between assets of extremely high liquidity and credit quality (Level 1 assets) and assets of high liquidity and credit quality (Level 2 assets).
    - Level 1 assets may comprise, *inter alia*, cash and central bank reserves, as well as securities in the form of assets representing claims on or guaranteed by central or regional governments, local authorities or public sector entities. The EU regulation also provides for greater recognition of extremely high-quality covered bonds (EHQCBs).
    - Level 2 assets are divided into Level 2A and Level 2B assets.
        - Level 2A assets include high-quality covered bonds (HQCBs), considered to be more liquid and, therefore, subject to lower haircuts.
        - Level 2B assets include certain non-residential mortgage-backed securities, with additional eligibility criteria:
            - STS label (which de facto eliminates many asset classes such as SMEs)
            - AAA/AA rating (which de facto eliminates securitisations from banks in countries rated below, given the sovereign ceiling)
            - Maturity cap of 5 years (which de facto eliminates Long-term securitisation such as mortgages or infrastructure)
            - Such additional eligibility criteria do not apply to any other asset class in the LCR regulation, and are a legacy of the stigma that prevailed after the GFC.

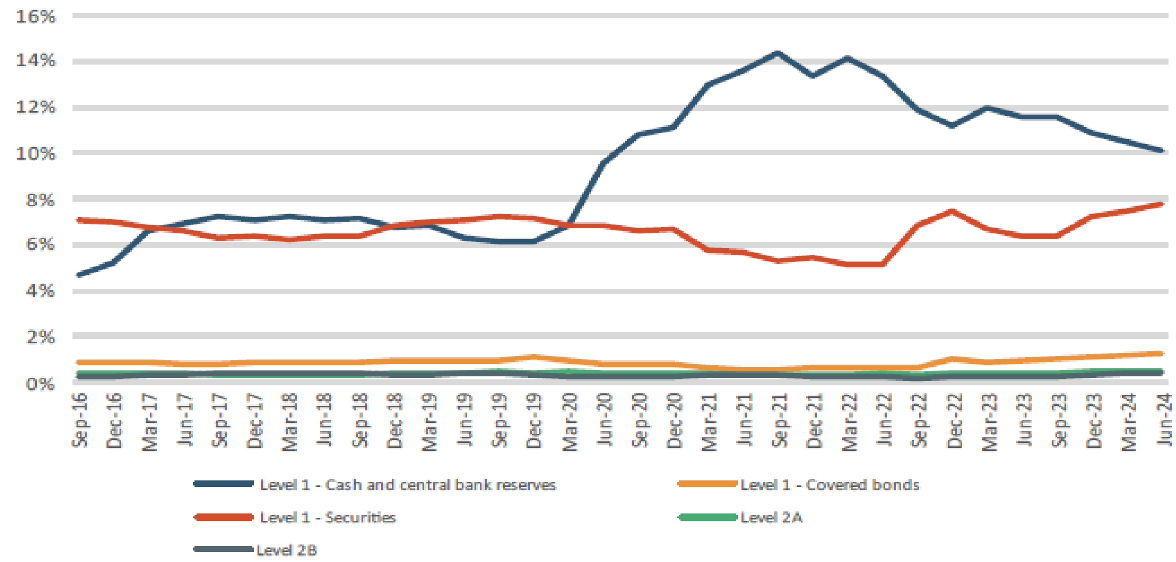
<u>Overview of eligible ABS and covered bond assets per category in the European Commission LCR delegated act:</u>

Asset type (HQLA)	**Tier**	**Cap applicable**	**Haircut applicable**
Covered bonds ECAI 1	1	70%	7%
Covered bonds ECAI 2	2A	40%	15%
Residential mortgage securitisation	2B	15%	25%
Auto loan securitisation	2B	15%	25%
Consumer loan securitisation	2B	15%	35%
Unrated high quality covered bonds	2B	15%	30%

Appendix II. Composition of Banks' HQLA portfolios

- In order to comply with the LCR ratio, the HQLA portfolio represents on average 20% of total bank assets[7], or about 5.6 €trn. This HQLA portfolio is composed of
  - Cash and reserves at the central banks : ~10% of total assets
  - Level 1 – securities : ~7%
  - Level 1 – Covered bonds : ~1%
  - Level 2A ~0,5%
  - Level 2B ~0.5%

Figure 9: Evolution of the composition of liquid assets (post-weight and before the cap) relative to total assets



Source: Supervisory reporting and EBA calculations.

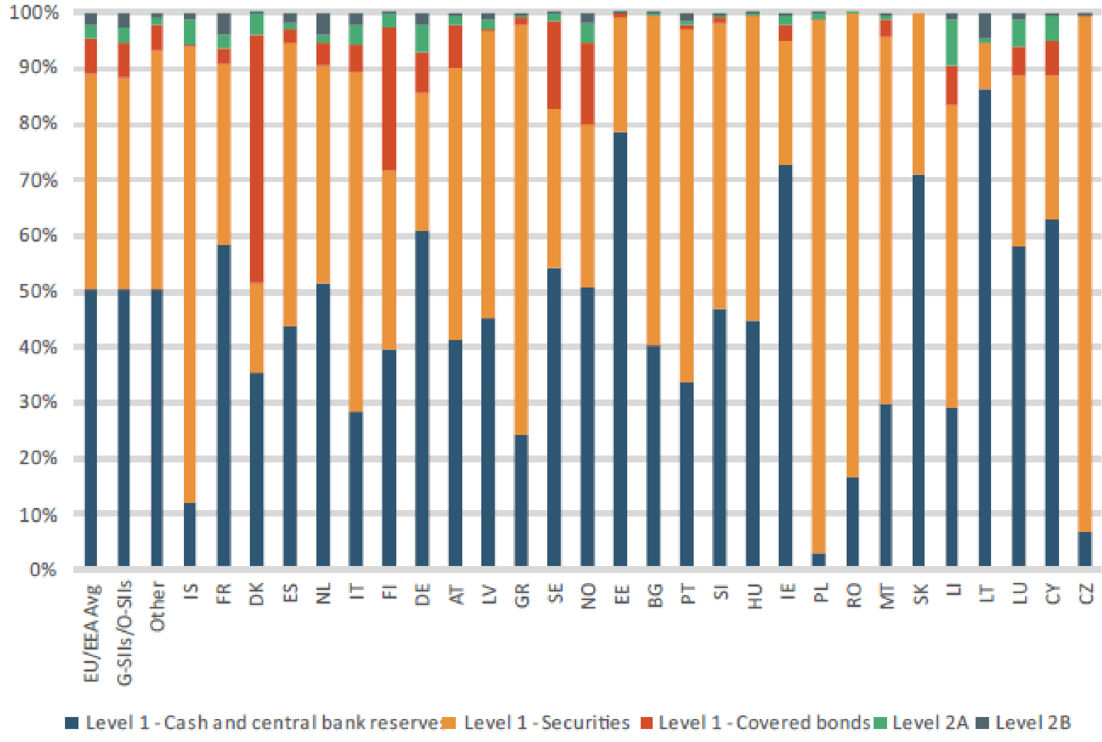
- Over time, the share of ABS in banks' HQLA assets has been fluctuating from 0.2% to a maximum 0.7%. This shows that the high haircuts applied in category 2B work as a total disincentive for banks to invest (or make market) in securitisation.
  - Actually, bank investors were de facto crowded out of the market, as potential buyers of senior securitisation tranches, given banks, even when buying STS tranches, are penalised with a significant haircut, much higher than covered bonds, which makes them too onerous to play a role in the management of the liquidity buffer.
  - The punitive LCR treatment also applies to banks' market making activities, which negatively impacts the overall secondary market liquidity.
  - Indeed, applying a 25% haircut in the LCR ratio means that, when a bank treasurer needs to buy an asset to cover a stressed cash outflow of 100, he has the choice between holding 100 of cash of central banks reserve, or buying an ABS amount of 133 or 100/(1-haircut). This will consume 133 of cash, or require to fund 133 at the bank's funding cost, with a (punitive) capital charge applying

[7] Source : EBA Report Dec 2024 – sample 88% of EU banking assets, representing €28trn

on 133. The additional yield offered by the senior ABS is far from compensating for this additional funding and capital costs.
    - To note, such haircuts are totally disproportionate with those applied by the ECB in its collateral policy, which are around 5%
- This disincentive for banks to invest in ABSs was probably an intended feature, inspired by the losses incurred by some banks having invested in US sub-prime securitisation. 15 years later, and given the highly protective framework developed, such disincentive is not anymore relevant.
- Instead, having EU banks investing and market making in other banks securitisation should be seen as beneficial from the point of view of EU financial integration.
    - Such financial integration is reported by the ECB [8]as lagging behind pre-GFC levels, despite the progress in the Banking Union: "*Despite the resilience demonstrated during crises, progress on financial integration in the euro area has been disappointing overall. Both price-based and quantity-based financial integration indicators have declined substantially over the past two years, with no sizeable increase since the inception of Economic and Monetary Union. Despite significant legislative efforts over the last decade, cross-border financial market activities and risk sharing have not grown, and it appears that a piecemeal approach has been taken towards many of the reform efforts.*"
    - Removing the barrier for banks to invest in other banks' securitisation would contribute to private sector risk sharing, while limiting the financial stability risks given the high quality of the senior tranches. It would contribute to convergence between funding conditions across EU banks, and ultimately EU economies. As per the ECB, "*In a well-integrated financial system, assets with the same risk-return characteristics cost the same, irrespective of the country in which they are traded. Financial integration therefore contributes to the uniform transmission of the European Central Bank's (ECB) monetary policy across the euro area.*"
    - In addition, allowing for an increased share of ABSs in HQLA portfolios would increase the diversification of the HQLA portfolio, and the resilience of its valuation, and in particular may reduce the sovereign/bank nexus.

- To note, the composition of HQLA buffers differs widely by country, notably as regards the split between cash and sovereign debt, and the share of Covered bonds (Level 1 and Level 2A), which reaches close to 50% in Denmark, and 30% in Finland. In no member state does securitisation (level 2B) represent more than 5%, with France, the Netherlands and Lithuania close to that level, and all other virtually non-existent. The difference between covered bonds and securitisation haircuts clearly impacts the willingness to engage.

[8] Source : ECB 2024 Biannual report on financial integration



Source: Supervisory reporting and EBA calculations.